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CLERK

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1942

NOS. 16, 32

GROUP OF INSTITUTIONAL INVESTORS and MUTUAL SAVINGS BANK GROUP,
Petitioners,

vs.

CHICAGO, TERRE HAUTE AND SOUTHEASTERN RAILWAY COMPANY, *et al.*,
Respondents.

RECONSTRUCTION FINANCE CORPORATION,
Petitioner,

vs.

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY, *et al.*,
Respondents.

BRIEF OF CHICAGO, TERRE HAUTE AND SOUTHEASTERN RAILWAY COMPANY AND OTHERS, RESPONDENTS.

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(For Names of Other Respondents See Inside Cover)

October 7, 1942

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Respondents.

BRIEF OF CHICAGO, TERRE HAUTE AND SOUTHEASTERN RAILWAY COMPANY AND OTHERS, RESPONDENTS.

This brief is filed in support of the judgment entered in the court below (R. 2321-2322) on the appeal of the Chicago, Terre Haute and Southeastern Railway Company, a lessor of certain railroad properties to the debtor; the trustees under the four mortgages securing Terre Haute

bonds;[1] two protective committees for the holders of Terre Haute bonds;[2] and two insurance companies owning Terre Haute bonds.[3] The Terre Haute is not a debtor in this proceeding, nor is it in reorganization in any other proceeding (R. 1876, 2158).

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[1] Mercantile National Bank of Chicago and Benjamin H. Rubenzik, trustees under the mortgage securing the Bedford Belt Railway Company First Mortgage 5% bonds, due July 1, 1938, constituting a first mortgage on 4.66 miles of the Terre Haute lines. $250,000 principal amount of bonds are outstanding in the hands of the public (R. 2169).

Girard Trust Company, trustee under the mortgage securing the Southern Indiana Railway Company First Mortgage 4% bonds, due February 1, 1951, constituting a first mortgage on 240.92 miles of the Terre Haute lines and a second mortgage on the property subject to the Bedford Belt mortgage. $7,287,000 principal amount of bonds are outstanding (R. 2169-2170).

Continental Illinois National Bank and Trust Company of Chicago, trustee under the mortgage securing Chicago, Terre Haute and Southeastern Railway Company First and Refunding Mortgage 5% bonds, due December 1, 1960, constituting a first mortgage on 115.17 miles of the Terre Haute lines and a junior mortgage on the properties subject to the Bedford Belt and Southern Indiana mortgages. $8,056,000 principal amount of bonds are outstanding (R. 2169-2170).

The First National Bank of Chicago, trustee under the mortgage securing Chicago, Terre Haute and Southeastern Railway Company 5% Income Mortgage Bonds, due December 1, 1960, constituting a junior mortgage on the properties subject to the First and Refunding Mortgage. $6,336,000 principal amount of bonds are outstanding (R. 2169-2170).

[2] Terre Haute First Lien Bondholders Committee, representing at the time of the District Court hearing a total of $2,539,000 principal amount of the First and Refunding Bonds, the Southern Indiana Bonds and the Bedford Belt Bonds (R. 1716-1718) and at the present time a total of $3,070,000 principal amount of said bonds; and Terre Haute Income Mortgage Bondholders' Committee, representing at the time of the District Court hearing $199,100 principal amount of the Income Mortgage Bonds (R. 1719) and at the present time $843,900 principal amount.

[3] Massachusetts Mutual Life Insurance Company, owner of $200,000 principal amount of the Southern Indiana bonds and $500,000 principal amount of the Income Mortgage bonds (R. 1439); and The Prudential Insurance Company of America, owner of $500,000 principal amount of the First and Refunding bonds and $500,000 principal amount of the Income Mortgage bonds (R. 1719).

In order that the entire Terre Haute case may be presented in a single brief for the convenience of the Court, the Terre Haute company, the First National Bank of Chicago, trustee, the Terre Haute Income Mortgage Bondholders' Committee, Massachusetts Mutual Life Insurance Company and The Prudential Insurance Company of America join in Points I-B and II hereof, in lieu of filing a separate brief.

OPINIONS BELOW

The reports and orders of the Interstate Commerce Commission are reported in 239 I. C. C. 485 and 240 I. C. C. 257 (Original Report, R. 2153-2269, and Order, R. 1258-1283; Supplemental Report, R. 1284-1317, and Order, R. 1319-1347). The opinion of the District Court is reported in 36 F. Supp. 193 (R. 1857-1899). The opinion of the Circuit Court of Appeals dated December 4, 1941, is reported in 124 F. (2d) 754 (R. 2297-2317). The opinion of the Circuit Court of Appeals dated January 12, 1942, on petition to modify its opinion of December 4, 1941, is not reported (R. 2334-2335).

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on December 4, 1941 (R. 2318, 2321-2322). The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925 (28 U. S. C. A. § 347). The petitions for certiorari in Nos. 16 and 32, which were filed on January 17, 1942, and February 28, 1942, respectively, were granted by this Court on June 8, 1942.

STATEMENT OF THE CASE

The issues dealt with herein pertain solely to provisions of the reorganization plan relating to the rejection of a lease to the debtor of certain railroad properties. The only questions are (1) whether the lease shall be adopted or rejected, and (2) if it is to be rejected, what the legal consequences of the rejection are. The statement of the material facts in petitioners' brief is substantially accurate, but that brief is primarily concerned with the relative treatment of the debtor's security holders, and the facts relevant to our issues, which are unrelated to such questions, are to some extent obscured by the extensive discussion of those other phases of the reorganization. For adequate presentation of this independent problem, we shall briefly state the essential facts material to the issues discussed herein.

In 1921 the Chicago Terre Haute and Southeastern Railway Company leased its entire railroad properties to the predecessor of the debtor for a term of 999 years (R. 2163). The consideration for the lease consisted of the lessee's agreement to maintain and replace the lessor's equipment, to pay the interest ($1,023,580 per year) and principal of the lessor's bonds, and to pay the expenses (up to $12,000 a year) of maintaining the lessor's corporate existence.[4] This lease was adopted by the debtor in connection with the reorganization of its predecessor in 1928 (R. 2162-2163).

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[4] The lease was introduced in evidence before the Interstate Commerce Commission as Debtor's Exhibit 63 (R. 283). It is included in the unprinted record.

Under its terms the lessee also covenanted to pay all taxes and to perform the covenants of the Terre Haute bonds and mortgages. The Terre Haute is required, upon termination of the lease, to repay the amount of principal payments made by the lessee, but such repayment may be made in bonds of the Terre Haute at par.

Since the institution of these proceedings and the appointment of trustees of the debtor's estate, the leased property has been held and operated by such trustees pending a determination whether to adopt or reject the lease. The period within which that determination might be made has been extended from time to time by orders of the District Court (R. 46, 84, 91, 121, 144, 164, 197, 198, 210, 232, 1351) and has not yet expired, the lessor meanwhile being enjoined from interfering with the trustees' possession (R. 48, 80). During this period substantial defaults under the lease have occurred. The trustees have refused, pursuant to order of the District Court, to pay the principal on bonds of the lessor which matured July 1, 1938 (R. 193).[5] They have likewise failed to perform the lessee's undertaking to maintain and replace the lessor's equipment. The debtor itself was in default on this latter obligation to the extent of approximately $5,000,000 when the reorganization proceeding was instituted on June 29, 1935, and by December 31, 1937, this amount had increased to over $7,000,000 as a result of failure to replace, upon retirement, equipment belonging to the lessor but held and used by the debtor's estate (R. 2170).[6] The trustees have, however, paid the current interest on the lessor's bonds and the expense of maintaining its corporate existence (R. 2169).

The Terre Haute properties possess a demonstrated earning power substantially in excess of the full interest requirements on Terre Haute bonds. (Terre Haute Dis-

[5] The Bedford Belt bonds.

[6] During the period from July 1, 1935, to June 30, 1940, there were retired and not replaced 896 units of equipment, including one steam locomotive, 718 coal cars and 151 flat cars (Terre Haute District Court Exhibit 24, introduced at R. 1688-1689).

trict Court Exhibits 16-23, introduced at R. 1686-1688.)[7] The Commission found that this earning power is sufficient to cover all interest requirements (R. 2213), and that a disruption of the lines would be to the disadvantage of both the lessor and the lessee (R. 1303). Since the beginning of the reorganization proceeding the debtor's estate has derived from its possession and use of the Terre Haute properties net earnings substantially in excess of all payments made by the estate to or for the account of the lessor. (Terre Haute District Court Exhibits 16-22, introduced at R. 1686-1687.)

However, the reorganization plan approved by the Commission provides that the Terre Haute lease shall not be adopted. A new lease at a substantially reduced rental (*e.g.*, reduction of interest rates, extension of bond maturities, and waiver of all equipment vacancies to January 1, 1939) is offered to the Terre Haute bondholders for acceptance, and it is provided that unless substantially all of those bondholders agree to the new lease, the existing lease shall be rejected as of the date, subsequent to confirmation of the plan, on which the District Court determines that such agreement has not been forthcoming (R. 1330-1331).

Attention is called to the fact that upon the intervention of certain Terre Haute bondholders in the proceedings before the Commission, and upon their objection that the Terre Haute—being a separate company and not a debtor in these proceedings—could not be reorganized herein, the Commission ruled that the Terre Haute bondholders are not such creditors of the debtor as could be bound by a confirmed plan for the Milwaukee which divested them of

[7] The earnings figures as shown by the record are compiled in Appendix A, *infra*, p. 57.

their existing liens (R. 2214). The parties and the courts below have acquiesced in that ruling (R. 1876).

We submit that the plan seeks to impose on the Terre Haute bondholders a reorganization in fact, the terms of which violate well-established principles of reorganization law; that the lease may not be rejected in the absence of findings that it is or will be burdensome to the lessee, and that no such findings have been made; and that if the lease is to be rejected, such rejection must take effect as of the date on which the debtor's reorganization proceeding was instituted, the lessor's claim for damages for breach of the lease must be measured as of that date, and the debtor's trustees must account to the lessor for the net earnings of the lessor's property since that date.

ARGUMENT.

I.

THE DECISION OF THE COURT BELOW THAT THE PROCEEDINGS SHOULD BE SENT BACK TO THE COMMISSION FOR FINDINGS WHICH WOULD ENABLE THE COURT TO EXERCISE AN INFORMED JUDGMENT AS TO THE LEGALITY OF THE PROPOSED DISPOSITION OF THE TERRE HAUTE BONDS, AND AS TO WHETHER THE TERRE HAUTE LEASE SHOULD BE REJECTED, WAS CORRECT.

A. There are no findings by the Commission warranting the disposition of the Terre Haute bonds in the manner provided by the plan, and the evidence would not support such findings if made.

The court below, following the enunciation of the law by this Court in *Consolidated Rock Products Co.* v. *Du Bois*, 312 U. S. 510, correctly held (R. 2314):

> "It is quite impossible to approve of the disposition of the Terre Haute bond issues without having more specific findings."

The disposition of the Terre Haute bond issues provided in the Milwaukee plan requires the Terre Haute bondholders to consent to various far-reaching changes in their rights under their bonds, their mortgages, and under the Terre Haute lease,—changes which are designed to effect what amounts to a reorganization of the Terre Haute. In default of such consent the Terre Haute lease is to be rejected. Rejection will be injurious to the lessor and its bondholders as well as to the lessee (R. 2213, 1303, 1879).

The required changes are (R. 1330-1331):

1. The existing mortgages on the Terre Haute properties shall be modified so that the bonds secured by the mortgages shall bear fixed interest at the rate of 2.75% a year and contingent interest in addition at the rate of 1.5% a year, the payment of the latter being contingent upon the earnings of the New Company to the same extent, in the same manner, and with the same limitations, as is provided in the plan with respect to the payment of interest on the General Mortgage Series A Income Bonds of the New Company. (It will be noted that the payment of this contingent 1.5% is conditioned not only upon the earnings of the New Milwaukee reaching a certain figure, but that it shall be payable only after an A and B Fund of not less than $2,500,000 a year shall have been provided out of system earnings for the New Milwaukee Company,—not for the Terre Haute, which will still remain a separate corporation).

2. The maturity of the Terre Haute bonds shall be extended so that they shall fall due as of the date of the First Mortgage Bonds of the New Company, viz., January 1, 1989 (R. 2216, 2227).

3. The Terre Haute bondholders shall waive all claims existing by reason of equipment vacancies existing under the Terre Haute mortgages up to the effective date of the plan (January 1, 1939). These equipment vacancies, amounting to $7,106,149 as of December 31, 1937, have considerably increased since that time (R. 331-332, 2212). It is worth noting in this connection that Mr. Sparrow testified (R. 332): "Had the Milwaukee fulfilled its obligation and replaced this new equipment, the net income of the Terre Haute would have been increased $162,798 in 1933, and $199,696 in 1934."

4. The New Company shall have the right, in the replacement of equipment retired after the effective date of the plan, to include equipment purchased under

equipment trusts, the lien of the trusts not to exceed 75% of the cost of the equipment.

5. The mortgages and the new lease shall contain appropriate provisions permitting, subject to the approval of the Commission, the abandonment of property which the Board of Directors of the New Company may deem it to the interests of the system to abandon.

6. The supplemental indenture to be executed in relation to the Terre Haute Income Mortgage Bonds shall declare null and void the guaranty of the Debtor's predecessor endorsed on the Income Bonds.

7. The new lease shall provide for the assumption by the New Company of the payment of the principal amounts of the mortgage bonds—modified as above—and for the payment by the New Company of the interest on the modified bonds at the new rates in addition to an amount not exceeding $12,000 a year for the taxes and corporate expenses of the Terre Haute.

8. The new lease shall contain like provisions for the abandonment of property and such provisions as may be deemed appropriate to facilitate a consolidation of the properties of the Terre Haute with those of the New Company.

It will be recalled that the Commission found that the Terre Haute bondholders are not such creditors of the debtor as may be bound by a confirmed plan of reorganization of the Milwaukee (R. 2214); that a consolidation in these proceedings of the Terre Haute with the debtor and the exchange of new system bonds for the Terre Haute bonds were impractical because of the Terre Haute's "outside status" (R. 1302-1303); and that the courts below and the petitioners acquiesced in these conclusions.

In spite of this the Commission proceeded to try to devise a method whereby it might accomplish indirectly what it admitted it could not do directly, viz., call upon the Terre

Haute bondholders to consent to what amounts to a reorganization of the Terre Haute, in default of which the lease of the Terre Haute to the Milwaukee is to be rejected.

We submit that this is an improper method of obtaining a desired result. It is clearly the *in terrorem* method frequently disapproved by this Court. *Fidelity & Deposit Co.* v. *Tafoya*, 270 U. S. 426, and cases cited therein; *United States* v. *Chicago, Milwaukee, St. Paul & Pacific R. R. Co.*, 282 U. S. 311.

Furthermore, the factual reorganization of the Terre Haute which the Commission seeks to accomplish is a reorganization which could not be imposed upon the Terre Haute if it were itself in bankruptcy reorganization.

The capitalization of the Terre Haute may be summarized as follows (R. 2163, 2169):

a) Bedford Belt First Mortgage 5% Bonds	$ 250,000
b) Southern Indiana Railway Company First Mortgage 4% Bonds	7,287,000
c) Terre Haute First and Refunding Mortgage 5% Bonds (These are the three first liens.)	8,056,000
d) The Terre Haute Income Mortgage 5's (These are the junior bonds.)	6,336,000
e) Capital stock	41,730 shares

The three first mentioned, (a), (b) and (c), are first mortgages, (b) overlapping (a), (c) overlapping (b) and (a), while (d) is a junior general lien on (c); (b) and (a). The properties of the several mortgage districts are different, the values of the properties are different, the earning powers are different, the bonds of the four issues have different market values, and are secured in various degrees.

If we assume for the moment that some sacrifice by the Terre Haute bondholders may be sought (such as would result from the adoption of the changes demanded)—for which we see no basis in law or in equity—then the distribution of this sacrifice among the Terre Haute bondholders must be on a "fair and equitable" basis, giving recognition to the "absolute priority rule," as declared by this Court. It is plain that the Commission's scheme, in this case, to procure a reduction of the Terre Haute rental by submitting a proposal to the Terre Haute bondholders, should require that the proposal shall be fair and equitable as among the Terre Haute bondholders. Since the proposal, if accepted, would in effect bring about what would amount to a reorganization of the Terre Haute, there should be proof of values, securities, properties and earning powers and findings upon which the Court can exercise an informed judgment as to how the proposed sacrifice may be equitably distributed among the bondholders. There is no such proof here, nor are there any such findings.

This situation presents the clearest possible case for the application of the rule laid down in the *Consolidated Rock Products* case—that there must be findings.

The plan provides that the holders of all the Terre Haute bonds, regardless of lien, security, maturity, earning power, or present interest rate, shall reduce their interest to 2¾% fixed, plus 1½% contingent, and that the maturities of all of them shall be extended to 1989—so that the Terre Haute stockholders—the Milwaukee holding 97% of the stock—shall have more. (For a reduction of the rent payable by the Milwaukee is no different from keeping the rent the same as now, reducing the interest charges on the bonds, and paying the difference to the stockholder as dividends, viz., to the Milwaukee.) A more flagrant violation of the

absolute priority rule—emphasized by this Court in the cases cited below, it would be hard to imagine.

Plainly, if the Terre Haute were in reorganization, under Section 77, such a rearrangement of its capital structure could not be supported for a moment, under the decisions of this Court in *Northern Pacific Ry.* v. *Boyd*, 228 U. S. 482; *Case* v. *Los Angeles Lumber Co.*, 308 U. S. 106; and *Consolidated Rock Products Co.* v. *Du Bois*, 312 U. S. 510.

It is unnecessary for us to summarize these decisions, or to quote from them at length, but we desire to call this Court's attention to its holding in the *Consolidated Rock Products Co.* case to the effect that "whether the company is solvent or insolvent in either the equity or the bankruptcy sense, 'any arrangement of the parties by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights of creditors comes within judicial denunciation.'"

We submit that there could be no findings made which could be the basis of the disposition of the Terre Haute bonds required by the plan short of evaluations of the several mortgage districts and of the earning power of each, showing that the security for each bond of the four issues was of identical value and that the earning power of each mortgage district was also identical per bond; obviously impossible. Not only has no such evaluation been made, but no evaluation at all has been made of the several Terre Haute mortgage districts.

Without appraisal of the Terre Haute mortgage districts and of the earning power of each, there can be no basis for findings and without appropriate findings there can be required of the Terre Haute bondholders no rearrangement or reorganization of the Terre Haute which readjusts

the interest rates and maturities of the several bond issues and the distribution of the required sacrifice as proposed in the present plan.

B. There are no findings by the Commission warranting rejection of the lease, and the evidence would not support such findings if made.

With regard to the Terre Haute lease, the court below correctly held (R. 2314);

> "Whether this lease should not now be terminated presents a separate question, which can only be determined when findings are made."

There is necessarily implicit in this holding recognition of the fact that the right of the Commission to require the rejection of a lease is not absolute but dependent upon the existence of certain conditions, viz., that the facts show that the lease is burdensome to the lessee.

Under this point it is our purpose to show:

1. That the Terre Haute lease is not burdensome, but profitable, to the lessee.
2. That the law of the land is that only leases burdensome to a bankrupt may be rejected.
3. That the power conferred upon the Commission by §77 to promulgate a plan which rejects an unexpired lease simply means that a plan may provide for the rejection of such leases as under the law of the land may be rejected in bankruptcy.

Before discussing these three sub-headings it is, we believe, appropriate to point out the error in the basis adopted by the Commission for its demand upon the Terre Haute bondholders for a reduction of their interest rates, for an

extension of the maturities of their bonds, and for waiver of their various other rights.

An examination of the Commission's reports shows that it has reached its decision against the adoption of the present lease by the New Company on the theory that it would not be equitable for the bondholders of a small road like the Terre Haute—being operated as part of the Milwaukee family—to keep their present bond interest rates when the bondholders of a big railroad system like the Milwaukee have to reduce theirs, regardless of the Terre Haute's contribution to system earnings (R. 2214-2216, 1302-1304).

But we submit that the measuring stick adopted by the Commission—viz., that it must reach a conclusion as to what it is equitable for the Terre Haute bondholders to have by comparing what they get with what the Milwaukee bondholders get—has no basis in law. The Milwaukee is one company and in bankruptcy. To do equity among the Milwaukee creditors, proper, there must be comparison of property and security values. But the Terre Haute is another company, and solvent. The fundamental test is: What are the earnings of the leased line? Do they support the fixed charges? Here the leased line's earnings do support the leased line's fixed charges—and several times over.

After the appointment of trustees for the debtor they prepared "Rules Governing the Preparation of the Separate Records to Show the Result of the Operation of the Terre Haute Lines." These rules were introduced in evidence without objection as Exhibit 140 (R. 575). Under these rules the trustees prepared information for the Commission showing the allocation of the actual earnings of the property, as they were then (viz., 1937) operated,

and assumed that their operation would continue as part of the debtor's system (R. 574-575).

Under these rules the earnings and expenses attributable to the Terre Haute and chargeable to it for the year 1936 were developed, and are shown by Debtor's Exhibit No. 139 introduced at the hearing before the Commission June 16, 1937 (R. 575-576). This exhibit shows that in 1936 the "net income available for fixed charges was $2,990,126 with a net income to the Milwaukee, after rental and other charges, of $1,825,226" (R. 576).

Mr. Scandrett, one of the trustees of the debtor, testified:

> "During this year (1936) there were 2,049,747 tons of company coal transported by the Terre Haute for the Milwaukee system other than the Terre Haute, foreign freight charges on which to the Milwaukee, if it had not had the Terre Haute lease, would have amounted to $2,106,406."

The year 1936, discussed by Mr. Scandrett, was adopted as what might be called a "typical year." The Commission in its report apparently does so, and describes 1936 as "not an unusually favorable period" (R. 2213).

These rules, which are in effect the segregation formula in this case, were applied at the request of these respondents and other parties to earnings in later years with the results shown in Appendix A, page 57.

The amount mentioned just above of $2,990,126 as being the income of the Terre Haute available for interest in 1936, was reached by allowing the Terre Haute regular tariff rates on fuel coal and other material hauled for the Milwaukee. Since there has been considerable discussion in the case as to whether such net income of the Terre Haute should be calculated on what is called "a tariff rate basis," or a "cost of service basis" (which in 1936 would

reduce the Terre Haute available income to $2,040,187) we respectfully direct the Court's attention to the testimony of Mr. Scandrett, one of the debtor's trustees, on this point, beginning at page 574. He stated (R. 577 *et seq.*):

> "In determining whether the Terre Haute Lines are profitable to the Milwaukee Railroad, it is immaterial whether full tariff rate, part tariff rate, or no tariff rate is allowed for the transportation of Milwaukee company coal by the Terre Haute.
>
> "Before the Milwaukee had the Terre Haute it had to pay tariff rates for the transportation of its company coal and, if it did not have the Terre Haute today, it would have to do so again.
>
> "The cost of hauling the company coal of the Milwaukee is in the expenses of the Terre Haute and, if no credit is given to it in its revenues for the haul of such coal, its net income is reduced, but the reduction is still a credit to the Milwaukee Railroad.
>
> "This is well stated by the following language taken from the report on the Terre Haute to the Court of Trustees Cummings and Haight:
>
> > "'In considering the question of whether the Terre Haute was or was not profitable to the St. Paul, it is clear that if no allowance or only a partial allowance is made in the Terre Haute revenues for the haul of the St. Paul Company's locomotive fuel, the difference between the amount allowed to the tariff rate remains in the treasury of the St. Paul.'"

Mr. Sparrow, testifying on this matter, stated (R. 327-328):

> "A. In 1925, the company coal transported was 2,721,512 tons, transported at a cost of 10 cents a ton; in 1926, 2,975,188 tons were transported at a cost of one-third of a cent a ton.

"Q. If you had not carried this coal over the Terre Haute, how would you have carried it?

"A. We might have moved it over the Terre Haute and the Chicago and Eastern Illinois, the same as before.

"Q. If you had paid tariff rates, what would they have been?

"A. They would have averaged 96½ cents in 1925.

"Q. That is 96½ compared with 10?

"A. Yes.

"Q. And in 1926 how much?

"A. 97 cents.

"Q. As compared with one-third of a cent?

"A. As compared with one-third of a cent.

In this connection for the twelve months prior to the lease of the Terre Haute the Milwaukee purchased 2,506,688 tons of company coal at various points on the Chicago & Eastern Illinois, Terre Haute, Illinois Central, Pennsylvania and other lines in Indiana and Illinois, on which it paid in freight charges to these roads a total of $2,970,425 which, if equated to rates prevailing in 1925, approximates $2,594,000."

Thereafter Mr. Scandrett testified as follows (R. 502):

"Q. Now, turning to the Terre Haute lease: Do you concur in Mr. Sparrow's conclusion that the Terre Haute lease is a valuable asset of the company?

"A. I think it is; I have no doubt of it."

Mr. Sparrow is now deceased, and was Vice President in charge of the Finance, Accounting and Real Estate Departments of the debtor (R. 271). His testimony on this point is found at R. 326-334.

Appendix A (*infra*, p. 57) shows that throughout the years 1924 to 1941, inclusive (but excluding 1921, 1922, 1923, 1930, 1931, 1932, which are not available), the Milwaukee averaged a net financial benefit annually from the Terre Haute lease, after payment of Terre Haute bond interest, of something in excess of $1,800,000 on the "tariff rate basis"; and on a "cost of service basis" throughout the years 1936 to 1941, inclusive, of $1,275,394, also after payment of Terre Haute bond interest.

It will be borne in mind that these revenues are the result of the application by the Milwaukee trustees themselves of their own formula devised to show the contributive value of the Terre Haute to the Milwaukee system.

Before leaving the subject of the profitable character of the Terre Haute lease to the Milwaukee system it is worth while to refer to the testimony of Mr. Sparrow at the hearing before the Commission August 5, 1935.

Mr. Sparrow had been testifying with regard to the profits earned by the Milwaukee from the Terre Haute property. He then shows the revenue gained by the Milwaukee from its haul over its own lines of commercial coal received by the Milwaukee from the Terre Haute, and says (R. 332-333):

> "The tons moved and revenue accruing to the Milwaukee on this business for the years 1933 and 1934 are as follows:
>
> "Tons of coal moved, 1933, 432,948 tons, in 1934, 489,387 tons. The Milwaukee's division of revenues from that tonnage in 1933 was $755,459 and in 1934, $813,319."

Exhibits 16-23 (R. 1686-1688) indicate that the years 1933 and 1934 are two of the low years reported in those exhibits covering 1924 through 1939. It is, therefore, not unreason-

able to assume that the Milwaukee's divisions of revenues from such tonnage in other years were at least as large.

The fact that the Terre Haute lease has been consistently the source of large profits to the Milwaukee cannot be seriously disputed.

Apparently recognizing that the plan's provision for a rejection of the Terre Haute lease, in case the Terre Haute bondholders do not agree to a reduction of interest and a waiver of other claims, cannot be supported under the "law of the land" in the face of the obviously very profitable character of the lease, there has been a consistent effort upon the part of the Institutional Investors Group, as well as some others, in the nature of a "smear campaign" against the Terre Haute. (See note p. 83, Brief of Institutional Investors Group in No. 16.) There has been much talk about the Terre Haute having been "a distress property controlled by a committee of Chicago bankers who wanted to liquidate and who had written the securities off the books of their banks as losses," and that "the terms upon which the property was acquired were improvident and to that extent adversely affected the financial condition of the St. Paul." These quotations in the note to petitioners' brief are from the report, issued over fourteen years ago, of the Interstate Commerce Commission investigation of the Chicago, Milwaukee & St. Paul, reported in 131 I. C. C. 615, et seq. and are from pp. 657-8.

In the first place we submit that whether or not the Terre Haute was a distress property back in 1921, is scarcely relevant to the questions now, 21 years later. Furthermore, it is significant that counsel for the petitioners in quoting from the Commission's report omits the first half of the sentence. The full sentence is as follows (the

underlined portion being that omitted by petitioners' counsel):

> "Conceding that Byram (the President of the St. Paul in 1921) was right in his judgment that the St. Paul needed a coal road such as the Terre Haute and that his judgment has been vindicated by the recent results, it is obvious that the terms upon which the property was acquired were improvident and to that extent adversely affected the financial condition of the St. Paul."

The only conclusion which can be reached is that the Terre Haute and the Milwaukee are each very important to the prosperity of the other. In the words of the Interstate Commerce Commission's Supplemental Report of June 4, 1940 (R. 1303):

> "* * * a disruption of the lines would be to the disadvantage of both companies. We have been and remain strongly of the opinion that the plan should provide some means of retaining the Terre Haute lines as a part of the system * * *."

In the face of the record of earnings by the Terre Haute—consistently profitable even through the depression years—counsel for the petitioners has permitted himself to say, at page 82 of his brief:

> "The Commission found the provisions of the existing lease to be so burdensome that an adoption of the lease by the reorganized company would 'jeopardize a successful reorganization of the Milwaukee,' and that this rejection 'is a necessary step in order that the process of reorganization of the Milwaukee may not be thwarted' (R. 1303)."

A more confused mosaic of disjointed fragments it would be hard to find.

Nowhere does the Commission or the court find that the Terre Haute lease is burdensome. The District Court was requested to pass upon this question by the First Lien Bondholders' Committee (Proposed Findings of Fact, Proposed Conclusions of Law, R. 1954-1956), but failed to do so (R. 1968, 1976-1977).

As a matter of fact, the closest approach to any determination by the District Court as to whether or not the Terre Haute lease was a valuable asset is found in the Order of the Court of August 27, 1935, directing the debtor's trustees to pay interest on the Terre Haute bonds (R. 75). This order was entered upon the petition of the trustees filed August 5, 1935 (R. 67) in which the debtor's trustees stated:

> "In the opinion of the Debtor's officers the leased property (the Terre Haute) is earning the rental charges and the benefits to the Debtor's system, direct and indirect, are greatly in excess of all charges that Debtor is required to meet under the terms of the lease * * *.
>
> "Because of the substantial economies effected and the substantial commercial traffic above mentioned, the lease is a valuable asset of Debtor and its operations of the property are profitable to a degree that amply justifies preserving the lessee's rights thereunder" (R. 71-72).

The extract from the Commission's Supplemental Opinion quoted, as above indicated, by petitioner's counsel, to the effect that some means should be worked out for retaining the Terre Haute lines as part of the reorganized system "without unduly jeopardizing a successful reorganization of the Milwaukee," plainly referred, not to a financial jeopardy for the New Company, but to the question as to whether or not Milwaukee bondholders would approve plan which did not disturb the Terre Haute's bonds.

The Commission, in its Report (R. 2215) and Supplemental Report (R. 1303), approached the question of rearrangement of system new funded debt using a comparison (a) of Terre Haute mileage with Milwaukee mileage, (b) of the values put upon the properties of each road by the Bureau of Valuations, and (c) of the size of the bonded debt of the Terre Haute with the bonded debt of the Milwaukee as a measuring stick. The Commission quoted a comment made before it by counsel for the debtor to the following effect:

> "'It may be doubted whether the holders of senior liens upon the Debtor's own 10,000 miles of property can be expected to consent to an arrangement which contemplates the continuance of the operation of the 10,000 miles, with no substantial return on their invested capital, merely to provide fuel consumption to support the payment of full fixed interest on the Terre Haute bonds, representing 300 miles.'"

This suggested doubt as to the possibility of procuring the consent of Milwaukee bondholders to the plan is plainly the "jeopardy" to which the Commission referred, and not to any burdensomeness in the Terre Haute lease itself.

Even if it should be argued that the comparatively early maturities of the Terre Haute bonds, viz., the Southern Indiana 4's, in 1951, and the First and Refunding 5's, and the Income Mortgage 5's in 1960, rendered the lease burdensome, it is at once obvious, in the light of the Terre Haute earnings, that the contention is unsound. As is shown in Appendix A, in the 6½-year period, July 1, 1935, to December 31, 1941, the trustees of the debtor earned a financial benefit from their operations of the Terre Haute exceeding $13,000,000. It is plain that operations on such a basis would pay off the entire Terre Haute funded debt in less than 12 years in addition to paying interest accruing without costing the Milwaukee a penny.

It has been suggested in the case that the existence of the claims of the Terre Haute arising out of the equipment vacancies (as above pointed out, aggregating more than $7,000,000) are sufficient alone to render the adoption of the lease burdensome. Such an argument, however, is purely theoretical and does not recognize the facts. While these vacancies exist, and while it is true that the Terre Haute equipment has been worn out, both on and off the Terre Haute line, and not replaced by equipment specifically allocated to the Terre Haute, the need for equipment on the Terre Haute has been met by the use of the Milwaukee's own equipment. This is the course which has been for some years past and now is being followed. There is no reason, if the lease is adopted, why this course cannot be continued with appropriate allocation to the Terre Haute of the necessary equipment.

We submit that there is no basis in the record for a conclusion that the Terre Haute lease is burdensome.

Apart from the existence of fraud or duress in the procurement of the lease, we know of no law in the land which permits of the destruction of a contract, which this lease is, short of proof and findings that the lease is burdensome to the bankrupt lessee.

The suggestion of the Commission that it would be inequitable as between Terre Haute bondholders and Milwaukee bondholders for the present rates of interest on the Terre Haute bonds to continue (R. 2212, 2215-2216, 1302-1304) we respectfully urge upon the Court, is contrary to the facts. It is the Terre Haute which has been inequitably treated. Under the lease the Milwaukee was bound to maintain Terre Haute equipment. In spite of this covenant, and in spite of the millions of dollars of financial benefit received by the Milwaukee from the Terre Haute

throughout the entire term of the lease, Terre Haute equipment has been worn out, run off the Terre Haute lines, and thrown away; without replacement, so that today the Terre Haute is not in any position to operate itself, and now, in this situation, the Terre Haute and its bondholders are confronted with the choice of reducing their interest, extending their maturity dates, and waiving all claims for replacement of equipment vacancies, or taking over a naked road which has been made incapable of separate operation by the Milwaukee itself which is now seeking a still more favorable "deal."

It has been urged by the petitioners that it would be inequitable not to disturb the Terre Haute bond interest rate in the light of the sacrifice required of the Milwaukee bondholders. While, as pointed out above, there is no basis in law or equity for a comparison of the Terre Haute bonds with the Milwaukee bonds, we submit that from whatever angle the subject is approached there would be no unfairness to the Milwaukee bondholders in the adoption of the Terre Haute lease. The Commission, the District Court, and the petitioners all admit the desirability of retaining the Terre Haute lease in the system (R. 1877, 1880, 2213). There has been some emphasis, however, upon the assertion that "the profitable character of the Terre Haute is dependent upon the continued operation of the rest of the system" (R. 1880), the Commission saying (R. 2213):

> "It may be safely concluded that the earning power of the Terre Haute is sufficient to cover all interest requirements, but this earning power is largely dependent on a continuation of the Milwaukee's coal traffic, together with the commercial coal traffic that accompanies it, and would be greatly diminished if such traffic ceased."

The fact remains that the Terre Haute is profitable to the Milwaukee and the Milwaukee is a basis for much

profitable traffic of the Terre Haute. The working arrangement between the two roads is mutually very beneficial. The record shows that at no time within the last twenty years has the Terre Haute been the cause of any financial embarrassment to the Milwaukee, but quite the contrary. The fact that one of these roads, the Milwaukee, has found itself twice within the last twenty years in financial difficulty would not seem to raise any question of equity as between Terre Haute bondholders and Milwaukee bondholders. The Milwaukee's difficulties have grown out of quite other factors. We see no equity in reducing the wage of the laborer whose efforts produce a profit for his employer in order to increase the wage of the laborers whose efforts produce a loss for his employer, at least where the employer is able to pay it. We suggest that the simile is exactly applicable.

Counsel for the bankruptcy trustees, in his brief, p. 21, quotes from Section 77(b), the provision that a plan of reorganization "may reject * * * unexpired leases," and apparently asserts that this provision authorizes rejection of leases even though the record shows them to be profitable.

We submit that one sentence, or part of a sentence, cannot be extracted from Section 77 and be construed apart from the general provisions of Section 77. Subdivision (e) of Section 77 provides for approval of a plan only if the plan "will conform to the requirements of the law of the land regarding the participation of the various classes of creditors and stockholders." The Terre Haute and its bondholders are, of course, as the court said (R. 1883) "the real parties in interest." They are entitled to receive payment of the cost of replacing the equipment vacancies (which as of December 31, 1937, aggregated $7,106,149, and have since increased, R. 2212; D.-Ct. Ex. 24, R. 1688-9) and

of the principal of the Bedford Belt bonds, due July 1, 1938, and still unpaid. The plan requires a waiver of these rights. We submit that any interpretation of the right of a plan to reject a lease must be interpreted in connection with "the law of the land," particularly where a threat of rejection of the lease is made to procure a different participation in the assets of the bankrupt. The law of the land, we believe, has been declared in the decisions of this and other courts referred to below, which show that "the law of the land" permits rejection of leases by a bankrupt only where the lease is burdensome.

Counsel for the bankruptcy trustees—at p. 22 of his brief—has quoted at length from the case of *Mercantile Trust Co.* v. *Farmers Loan & Trust Co.*, 81 Fed. 254; involving a reorganization of the "Frisco," emphasizing a part of the decision in that case. There the court declared that the question of rejecting a lease was primarily a business or administrative one to be determined by a decision as to whether rejection or adoption would be "of greater advantage to the trust estate" (p. 259) (viz., the test of burdensomeness). In that case, while the receivers decided against assumption of the lease, the question was referred to a special master, who, after taking evidence decided that it would be to the advantage of the trust estate to assume the lease and the assumption was therefore ordered. The court examined the facts and held (p. 260):

> "* * * The salient facts of the case all tend to the same conclusion. The first mortgages upon and the leases of the four branch lines in 1886 and 1887, the provision of the consolidated mortgage which we have quoted, (to the effect that all the mortgaged railroads and all their capital stock held under the consolidated mortgage, should be sold as one property at public auction) the allegations of the appellant in its bill that the unity of the railroads covered by the consolidated mortgage in one system was an important ingredient of their value, and that their severance would be

> ruinous to every interest in them, and the fact that these leased lines have been constantly operated by the San Francisco Company under their leases, show that the shrewd and experienced men who organized the Frisco System, those who made and accepted the consolidated mortgage upon it as security for more than $14,000,000 of bonds, and the trustee under that mortgage itself, until 1894, believed that the retention and operation of these branch lines under their leases was a benefit to the railroad system covered by that mortgage, and acted upon that belief. We find nothing in the record in this case to convince us that the master or the court below made any mistake of fact or committed any error of law in coming to the same conclusion."

Practically the same remarks could be made in the case at bar. The officers of the Milwaukee, the debtor's plan, the debtor's trustees, have all testified to the profitable nature of the Terre Haute lease and in favor of its adoption by the New Company, as well as the Trustee and the committee representing the Milwaukee 5's of '75. Even the petitioners in their plan proposed either the adoption of the lease (provided past defaults should be waived) or the issuance of the New Company's new first mortgage 4% bonds in exchange for Terre Haute bonds dollar for dollar (R. 2189-90). Plainly the attack by the petitioners on the Terre Haute bonds at the present time is made merely for the purpose of pushing the plan through.

Our interpretation of the statute is supported by the Report of what transpired at the hearing before the Committee on the Judiciary of the House (74th Congress, First Session) on H. R. 6249, "a bill to amend the Railroad Reorganization Act of 1933." The question of rejection of railroad leases was before the Committee, and the discussion shows at pp. 145, 146, and 272 of the Report that it was the repudiation of unprofitable leases which was under consideration.

The existing law, we submit, was at the time of enactment of these provisions and still is that a trustee in bankruptcy or a receiver in equity may reject a *burdensome* lease. A careful search of the decisions has failed to disclose any principle of law or any single decision warranting the rejection of a profitable leasehold by a trustee in bankruptcy.

American Brake Shoe & F. Co. v. *New York Rys. Company*, 278 Fed. 842.

In this case a receiver was appointed for the New York Railways. He applied to the court for instructions with regard to a lease in which the New York Railways Co. was lessor and the Frank A. Munsey Co. apparently lessee. The question was referred to a special master who advised that the receiver might notify the lessee of the receiver's disaffirmance of agreements in the lease for renewal and of covenants by the lessor to furnish heat, electricity, etc., after April 30, 1920, and of the receiver's intention to retake possession after the lapse of a reasonable time for the lessee to remove. The court, however, said (pp. 843-844):

> "The theory of an equity receivership, such as this, is that the court is preserving the property. Hence, if rent cannot be paid by the receiver, or, in the light of financial conditions, has become burdensome, and it appears that loss may or will ensue, the lease may be disaffirmed.
>
> "• • • When a lessee under a lease takes possession, the lease presupposes continuance, even in the face of a receivership of the landlord, so long as the landlord's receivership estate is not burdened or put to loss, and by 'burdened' is not meant that the lease could be more profitable, but that it entails a positive loss or encroachment on the corpus or capital of the estate.
>
> • • •

> "In the case at bar there is no evidence that the lease is a burden in the sense defined *supra; i. e.*, that in carrying out its affirmative obligations the estate suffers an actual loss as distinguished from the obtaining of a more profitable rental."

Two recent decisions of this Court support the view that only burdensome leases may be rejected.

> *Palmer* v. *Webster & Atlas Bank*, 312 U. S. 156, 163;
>
> *Philadelphia Company* v. *Dipple*, 312 U. S. 168, 174.

In the *Palmer* case the decision involved the use by the New Haven Railroad and its lessors, the Boston & Providence Railroad and the Old Colony Railroad, of the South Station in Boston, and the arrangement by which the New Haven and its two lessors were obligated to pay the South Station's taxes and bond interest. In the course of the decision this Court, interpreting § 77, said (p. 163):

> "Section 77(c)(2) accords the trustees of a railroad in reorganization the right to reject burdensome leases."

In *Philadelphia Company* v. *Dipple*, which involved a reorganization under Section 77B, and the rejection of a lease, this Court said (312 U. S., p. 174):

> "Notwithstanding the fact that § 77B gives no specific authority to trustees in reorganization to reject burdensome leases or contracts, it is well settled that they have that right and are accorded a reasonable time within which to exercise it."

In *Butterworth* v. *Degnon Contracting Co.*, 214 Fed. 772, the court was passing upon the obligation of a receiver

in equity in relation to an uncompleted contract of the debtor for performance of certain services. The court said (p. 773):

> "* * * On taking possession as receiver he found a contract which might develop into an exceedingly valuable asset. Had he repudiated it, without investigation, he would have been guilty of a clear dereliction of duty. *He was in duty bound to proceed with the contract if it were beneficial to the estate administered by him and to abandon it if not beneficial.* He had a reasonable time to investigate before deciding this problem. He concluded to try the experiment of transporting some of the stone and soon found that he could not continue without loss to the estate. This being so, it was his duty to discontinue. He had no right to go on with a contract which was certain to subject the creditors whose interest he was bound to protect, to additional loss." (Italics ours.)

In *Brown* v. *O'Keefe*, 300 U. S. 598, this Court, in passing upon the rejection of an executory contract, said (p. 602):

> "Whatever title or inchoate interest may have passed to the trustee was extinguished by relation as of the filing of the petition when the trustee informed the court that the shares were *burdensome* assets, and was directed by the court to abandon and disclaim them." (Italics ours.)

In the recent case of *In re Chicago Rapid Transit Co.—Chicago Junction R. R. Co.* v. *Sprague*, 129 F. (2d) 1, a proceeding looking towards the rejection of the lease of a streetcar line was under consideration. The trustees of the Chicago Rapid Transit Company sought an order permitting them to reject the lease of the Chicago Junction Railroad. The proceeding was founded upon the contention of the trustee that the lease was burdensome, and resulted in an order approving the rejection of the lease on

that ground. The test of burdensomeness was referred to frequently throughout the opinion. The court said (pp. 4-5):

> "* * * The court found that it had jurisdiction, without permission of the Illinois Commission, to determine whether the lease was burdensome and should be abandoned; that it was in fact burdensome and should be rejected, and that there had occurred no such undue delay as would estop the trustees from electing not to adopt.
>
> * * * *
>
> "Even before the more recent extensions of bankruptcy jurisdiction by Sections 75, 77 and 77B, 11 U. S. C. A. §§ 203, 205, 207, a trustee was allowed to abandon assets deemed valueless and, in operation and maintenance of the assets, in liquidation and in equitable division of proceeds, to reject burdensome leases.
>
> * * * *
>
> "It (the bankruptcy court) may cancel a burdensome lease, * * *."

Nowhere throughout the opinion is there a suggestion that a profitable lease may be rejected.

The learned judge in the District Court below describes the evidence before him with regard to the value of the Terre Haute and the advantages gained by the debtor from the lease (R. 1877). The evidence referred to at this point in the judge's decision is the only evidence in the case on the question. The judge summed it up as follows:

> "The exhibits introduced in evidence before the Commission and before the Court, showing an allocation of earnings to the Terre Haute lines upon the basis followed by the accountants in the preparation of the exhibits, disclosed that the earnings so allocated to these lines are, and for some years have

been, substantially in excess of the rental required to be paid in the form of interest on the outstanding bonds" (R. 1877).

A plan, therefore, which calls for rejection of the Terre Haute lease in the absence of findings, based on proof, that the lease is burdensome, is fatally defective. Not only are there no such findings here, but we submit the uncontradicted evidence shows that they could not be sustained if made.

The courts below and the Commission should be instructed that in the absence of proof and findings that the Terre Haute lease is burdensome, provision for its rejection is unauthorized.

II.

THE PROVISION OF THE PLAN THAT REJECTION OF THE LEASE SHALL TAKE EFFECT AS OF A FUTURE DATE VIOLATES THE ESTABLISHED PRINCIPLE THAT REJECTION TAKES EFFECT AS OF THE BEGINNING OF THE PROCEEDING.

The reorganization plan approved by the Commission provides that the Terre Haute lease shall be rejected as of the date (subsequent to confirmation of the plan) on which the District Court determines that the Terre Haute bondholders have refused to acquiesce in the making of a new lease at a reduced rental (R. 1331). This provision requires that the lessor's damages for breach of the lease shall be measured as of the indefinite future date specified, and deprives the lessor of its right to an accounting and to any net earnings of its property since the beginning of the proceeding.

In these respects the plan violates the fundamental principle, applicable to all forms of insolvency proceedings,

whether ordinary bankruptcy, equity receivership or bankruptcy reorganization, that the rejection of an asset, including an executory contract or lease, takes effect by relation as of the beginning of the proceeding.

Brown v. *O'Keefe*, 300 U. S. 598, 602;

Central Trust Co. v. *Chicago Auditorium*, 240 U. S. 581, 590-593;

Palmer v. *Palmer*, 104 F. (2d) 161, 163;

Pennsylvania Steel Co. v. *New York City Ry. Co.*, 198 Fed. 721, 744;

Central Manhattan Properties v. *D. A. Schulte, Inc.*, 91 F. (2d) 728, 730.

The Circuit Court of Appeals did not deal with this question in its opinion, presumably because the reversal for lack of adequate findings was thought to render consideration of other defects in the plan unnecessary. The judgment entered by that court on the appeal of these respondents (R. 2321-2322) is, however, fully justified and required by the plan's violation of law in this respect and should be affirmed on that ground. In proceedings of this nature it is of the utmost importance that the Commission be instructed as to the correct legal principles applicable to matters wherein it has erred in order that the ultimate consummation of the reorganization may not be further delayed by a repetition of the same error in a new plan. For this reason we earnestly and respectfully submit that the legal consequences of rejection of the Terre Haute lease in this case should be judicially defined at this time.

A. The lessor's claim for damages for breach of the lease must be measured as of the date on which the proceeding was instituted.

Upon rejection, the lessor is entitled to prove a claim against the debtor for damages resulting from the latter's breach of the lease. Such damages are measured by the difference between the value of the rent reserved and the rental value of the remainder of the term. *Connecticut Ry. Co.* v. *Palmer*, 305 U. S. 493, 501, 504.

The applicable statutory provision is contained in the last paragraph of subdivision (b) of section 77 of the Bankruptcy Act, wherein it is provided:

> "* * * In case an executory contract or unexpired lease of property shall be rejected, or shall not have been adopted by a trustee appointed under this section, or shall have been rejected by a receiver in equity in a proceeding pending prior to the institution of a proceeding under this section, or shall be rejected by any plan, any person injured by such nonadoption or rejection shall for all purposes of this section be deemed to be a creditor of the debtor to the extent of the actual damage or injury determined in accordance with principles obtaining in equity proceedings."

This Court has held that the above provision places leases upon the same basis as executory contracts and that damages for breach are to be determined by the rules applicable to such contracts. *Connecticut Ry. Co.* v. *Palmer*, 305 U. S. 493, 505.

It is well established that the damages resulting from breach of an executory contract must be measured as of the beginning of the proceeding, since it is at that time that the anticipatory breach, upon which the claim is necessarily based, occurs. *Pennsylvania Steel Co.* v. *New York City Ry. Co.*, 198 Fed. 721, 735, 744; *Samuels* v. *E. F. Drew & Co.*, 292 Fed. 734, 736-738; *Napier* v. *People's Stores Co.*,

98 Conn. 414, 426-427, 120 Atl. 295, 299, 33 A. L. R. 499, 507-508. Under the express provisions of section 77(b), above quoted, and the ruling of this Court in *Connecticut Ry. Co.* v. *Palmer*, 305 U. S. 493, the same rule must apply here. *In re New York, N. H. & H. R. Co.* 30 F. Supp. 541, 543.

In the brief filed on behalf of the debtor's trustees it is apparently contended (p. 28) that the plan's violation of law in this respect is immaterial, for the asserted reason that the lessor will receive the stipulated rental to the effective date of rejection prescribed by the plan. This contention assumes that the full rent has been and will be paid until such time as the lease is rejected. The fact is, however, that there have already been substantial defaults since the institution of the proceeding and there is every reason to believe that they will continue.

In any event, however, the measure of the lessor's claim for damages against the debtor is the difference between the value of the rent reserved and the rental value of the remainder of the term, and those values, if determined as of the beginning of the proceeding in 1935, will be substantially different from what they would be if determined as of a date seven or more years later. Whether the amount of rental payments made in the interim will offset the change in values cannot be determined until an opportunity has been presented to prove what those values were at the beginning of the proceeding. No opportunity to make such proof has yet been afforded in this case.

B. In the event of rejection operation subsequent to the beginning of the proceeding must be for the account of the lessor; the latter is liable for all losses and is entitled to any net earnings.

The estate of a debtor in insolvency proceedings, acting through its trustee or receiver, is privileged to retain and

use leased property for a reasonable time pending determination whether to adopt or reject the lease, without incurring liability thereunder. This privilege is conferred by law, regardless of the consent of the lessor, for the purpose of permitting an informed judgment as to whether it will be to the benefit of the estate to adopt. *North Kansas City Bridge & R. Co.* v. *Leness*, 82 F. (2d) 9, 12; *General Finance Corporation* v. *New York State Rys.*, 54 F. (2d) 1008, 1009; *Johnson* v. *Emerson Phonograph Co.*, 296 Fed. 42, 45.

The estate's ultimate decision, whether it be to adopt or reject, is said to relate back to the beginning of the proceeding and to take effect as of that time, an expression which may be said to have become a term of art. In the event of adoption, the rights of the parties during the entire period are defined by the lease. Conversely, in the event of rejection, the estate remains at all times a stranger to the lease, the rights of the parties during the course of the proceeding are not controlled by it, and the lessor can assert no rights under it against the estate. Where rejection occurs, therefore, the obligations of the estate to the lessor on account of its retention and use of the latter's property cannot be determined by reference to the terms of the lease. *Samuels* v. *E. F. Drew & Co.*, 292 Fed. 734, 739; *Atchison, T. & S. F. Ry. Co.* v. *Hurley*, 153 Fed. 503, 510, affirmed, *Hurley* v. *Atchison, Topeka & Santa Fe Ry.*, 213 U. S. 126.

In the ordinary non-railroad case (*e.g.*, a lease of a store building) it is established that the estate is obligated to pay the reasonable rental value of the property for the period of its possession. *Irving Trust Co.* v. *Deasmore*, 66 F. (2d) 21, 23; *Oscar Heineman Corporation* v. *Nat Levy & Co.*, 6 F. (2d) 970, 975; *Gardner* v. *Gleason*, 259 Fed. 755, 759. In such cases, of course, neither the estate nor the

lessor is under any duty to employ the leased property in the conduct of any particular business, and if the estate elects to pursue a business venture it does so for its own account and the financial results thereof in no way concern the lessor, the entire risk of loss and chance of gain resting with the estate.

In the case of a railroad lease, however, a different situation prevails. The leased railroad property must be continued in operation in the public interest, and the law imposes upon the lessor a duty to continue such operation. For this reason it has long been established that, in the event of ultimate rejection, the estate's operation, since it constitutes performance of a duty to which the lessor is subject, is for the account of the lessor and not for the account of the estate. Thus it is uniformly held in equity receivership proceedings that the lessor is responsible for all losses and is entitled to receive, not the stipulated rental nor the reasonable rental value, but instead the net earnings. *Pennsylvania Steel Co.* v. *New York City Ry. Co.*, 198 Fed. 721; *Westinghouse Electric & Mfg. Co.* v. *Brooklyn Rapid T. Co.*, 6 F. (2d) 547; *American Brake Shoe & Foundry Co.* v. *New York Rys. Co.*, 282 Fed. 523; *Mercantile Trust Co.* v. *Farmers' Loan & Trust Co.*, 81 Fed. 254, 258.

This principle is equally applicable to proceedings under Section 77.

In *Palmer* v. *Webster & Atlas Bank*, 312 U. S. 156, 161-162, 167, this Court upheld as the exercise of a sound discretion action of a district court which it recognized (312 U. S. at page 162) had been based in part upon application of the principle that rejection relates back to the beginning of the proceeding and that thereafter operation by the debtor's estate is for the account of the lessor, the latter being responsible for all losses incurred. In *Palmer*

v. *Palmer*, 104 F. (2d) 161, the Circuit Court of Appeals for the Second Circuit, on the basis of the same principle, held the lessor responsible for losses incurred by the lessee's trustees and required the lessor to repay all rental payments which had been made by the trustees. The applicability of the principle was likewise announced in *In Re Chicago, R. I. & P. Ry. Co.*, 110 F. (2d) 395, 399.

Section 77 itself contains no express provision covering the period of operation prior to the time when the determination to reject is reached. It does, however, contain express provisions with respect to the operation subsequent to such determination. Subdivision (c) (6) provides:

> "If a lease of a line of railroad is rejected, and if the lessee, with the approval of the judge, shall elect no longer to operate the leased line, it shall be the duty of the lessor at the end of a period to be fixed by the judge to begin the operation of such line, unless the judge, upon the petition of the lessor, shall decree after hearing that it would be impracticable and contrary to the public interest for the lessor to operate the said line, in which event it shall be the duty of the lessee to continue operation on or for the account of the lessor until the abandonment of such line is authorized by the Commission in accordance with the provisions of section 1 of the Interstate Commerce Act as amended."

The obvious purpose of this provision is to require the lessee's estate, in the public interest, to continue operation if the lessor is unable to do so. It was undoubtedly inserted in recognition of the fact that, in its absence, rejection might result in loss of railroad service to the public. It was, of course, unnecessary to make such provision for the period prior to rejection, since of necessity the debtor's estate would operate the property until that time.

Having imposed upon the estate this duty to continue operation even after rejection, it was necessary also to pro-

vide where the risk of loss and the chance of gain should rest, and the statute expressly extended the equity rule to cover this additional period. Clearly, it was assumed and intended that for the period prior to rejection there would apply the principles which had long prevailed in equity, against which background Section 77 was enacted. *Cf. Case* v. *Los Angeles Lumber Co.*, 308 U. S. 106, 115, *et seq.*

Further evidence that Section 77 contemplates the applicability of the prevailing equity doctrine is found in that part of subdivision (b), quoted *supra* page 35, which provides that the lessor's claim for damages against the debtor shall be determined in accordance with principles obtaining in equity proceedings. This provision requires determination of the lessor's actual injury resulting from the debtor's breach, and, as we have shown in subdivision A of this Point II, the measure of that injury is the present value of the rent reserved less the present rental value of the remainder of the term as of the date on which the proceeding was instituted. The rental value of the remainder of the term is determined by the future earning power of the property, which is measured by the actual earnings after the date of breach so far as known. *Palmer* v. *Connecticut Ry. Co.*, 311 U. S. 544. Since in determining the amount of the lessor's actual injury there is deducted the present value of the earnings of the property after the date of the debtor's petition, it follows that the lessor is entitled to such earnings and no part of them may be appropriated by the debtor's estate. *Cf. City Bank Co.* v. *Irving Trust Co.*, 299 U. S. 433, 443-444.

The present plan violates the established principle that, in the event of rejection, operation from the beginning is for the account of the lessor. The briefs of those who support the plan seek to avoid this conclusion by asserting that

the principle applies only where it will benefit the estate, that is, where it will require the lessor to bear losses or to accept net earnings less than the rental stipulated in the lease. Thus, the brief filed on behalf of the debtor's trustees states (p. 26) that the authorities "are unanimous in holding that the trustee in no case will be required to pay during the trial period more than the stipulated rent." The contention is simply an assertion that the estate, though it repudiates the lease and is subject to none of its burdens, is nevertheless entitled to take such of its benefits as it desires.

The essentially inequitable character of the contention is apparent on its face. It is fundamental that one may not take the benefits and at the same time repudiate the burdens of a contract. *National Bank* v. *Matthews*, 98 U. S. (8 Otto) 621, 629; *Sioux City Terminal R. & W. Co.* v. *Trust Co. of N. A.*, 82 Fed. 124, 135. If a receiver or trustee desires to take the benefits of an executory contract, he must assume its full obligations. *Greif Bros. Cooperage Co.* v. *Mullinix*, 264 Fed. 391, 397; *Atchison, T. & S. F. Ry. Co.* v. *Hurley*, 153 Fed. 503, 510, affirmed on other grounds, *Hurley* v. *Atchison, Topeka & Santa Fe Ry.*, 213 U. S. 126.

The authorities cited by the parties supporting the plan do not support their contention. *Sunflower Oil Company* v. *Wilson*, 142 U. S. 313, involved two questions: (1) whether a seller of equipment to a railroad could compel the latter's receiver to carry out the contract of sale, and (2) whether the receiver could recover from the seller freight charges due on account of freight transported for the seller, the contract of sale providing that such freight charges should be applied to the purchase price. The case involved no question as to the disposition of the net earnings of leased property and has not the remotest bearing upon the issue here presented. *City and County of Denver* v. *Stenger*, 295 Fed. 809, involved a petition of a city to compel

the receiver of a street railway to pay the compensation stipulated in a franchise contract which the receiver had not elected either to adopt or reject. It was held that in the event of rejection the measure of the receiver's liability would be the reasonable value of his use of the franchise, which the court found, on the facts, to be the amount stipulated in the contract. The city was seeking only that amount and no question was presented as to whether it could have obtained more if the reasonable value of the use had been greater. The court stated, by way of dictum, that the receiver would be required to pay the reasonable value of his use not exceeding the amount stipulated in the contract. This dictum is untenable in the light of the established rule that an executory contract or lease is not binding on a receiver unless adopted by him, and conflicts with the court's statement (p. 817) that the measure of the receiver's liability "is not that prescribed by the contract," and with the court's ruling (p. 818) that interest could not be allowed on payments due from the receiver because such payments were not covered by any contract. *Oscar Heineman Corporation* v. *Nat Levy & Co.*, 6 F. (2d) 970, and *Harris Trust & Savings Bank* v. *Chicago Rys. Co.*, 39 F. (2d) 958, are equally inapplicable. Neither involved any question as to the disposition of the net earnings of leased property nor any question as to whether the receiver's liability might exceed the amount stipulated in the rejected contract.

Furthermore, in each of the foregoing cases the receiver's operation could not possibly be said to be for the account of the party seeking compensation, and the latter would not have been held responsible for losses. The *Sunflower Oil Co.* case involved a seller of equipment to a railroad; *City and County of Denver* v. *Stenger* and *Harris Trust & Savings Bank* v. *Chicago Rys. Co.* involved municipalities which

had granted franchises to use the public streets to street railway companies; and *Oscar Heineman Corporation* v. *Nat Levy & Co.* involved a lessor of ordinary real estate. Whatever limitations there may be on the extent of a receiver's liability in cases arising in a field where operation is not for the account of the lessor, such limitations can have no possible application where, as here, the converse is true and the lessor is chargeable with all losses incurred.

The question whether profits in excess of the stipulated rental may be retained by the lessee's estate, despite rejection of the lease, has been directly presented for decision in only two cases. In both it was held that the estate must account to the lessor for the entire amount of the profits. *Westinghouse Electric & Mfg. Co.* v. *Brooklyn Rapid T. Co.*, 6 F. (2d) 547; *Central Manhattan Properties* v. *D. A. Schulte, Inc.*, 91 F. (2d) 728. In the *Westinghouse* case the receiver had paid all installments of rent, with the exception of $87,476.93 in state taxes, that fell due between the date of his appointment and the date as of which he sought to reject the lease, and net earnings during the period, after payment of all expenses and rentals other than such state taxes, amounted to $88,956.51. (See report of the special master and opinion of the district court in 291 Fed. 836, 842, 851-854, 856, 857.) The receiver attempted to sustain the same position as that here asserted by the supporters of the plan. In overruling the contention, the Circuit Court of Appeals for the Second Circuit said (6 F. (2d) 547, 549-550):

> "* * * If the receiver is not virtute officii the assignee of the term, if he remains a stranger to the lease until he adopts it, he must, upon definitive action of adoption or rejection, be held to have occupied from the beginning the same position that he ultimately assumes. If he rejects, he must account from the beginning as one who rejects, and if he assumes, he must

from the beginning conform to the terms of the contract he has assumed.

* * *

"Theoretically there is no difference in the accounting result, whether rent be paid or not; if net earnings equal or exceed rent for the provisional period. If the earnings over expenses other than rent be X, and the rent be Y, then if the receiver has paid rent he accounts for X-Y, and if he has not paid rent he accounts for X."

In *Central Manhattan Properties* v. *D. A. Schulte, Inc.*, 91 F. (2d) 728 (a Section 77B proceeding) it was held that a debtor's trustee who does not physically occupy leased premises, but collects the sub-rents on sub-leases thereof made by the debtor, must, unless he adopts the lease, turn over to the lessor the entire sub-rents collected, whether more or less than the rental stipulated in the lease.[8] The court said (p. 729):

"* * * Quite independent and in addition to it is the duty of all trustees to restore any gain or profit they may have made out of the res; that is fundamental to the relation in all its forms. The sub-rents, though they were payable in advance, were not on that account any the less a profit derived by the debtor from its retention of the premises during the month of June; that profit belongs to the lessor at whose expense it was procured; it is recoverable in equity."

The principle that, in the case of railroad leases, operation by the lessee's receiver or trustee prior to rejection is for the account of the lessor cannot be one-sided in its applica-

[8] In the earlier case of *In Re United Cigar Stores Co. of America*, 69 Fed. (2d) 513, relied upon in the briefs filed by supporters of the plan, the same court held that under such circumstances the trustee was not liable for the reasonable rental value of the property. In the *Central Manhattan Properties* case the court expressly pointed out that the question of the trustee's liability to account for profits had been neither presented nor passed upon in the *United Cigar Stores* case. (See 91 Fed. (2d) 728 at p. 729.)

tion. The financial results of the operation cannot change the nature of the relationship between the lessor and the debtor's estate. The lessor is liable for losses. It is entitled only to the net earnings when they are less than the stipulated rental. It is equally entitled to the net earnings when they exceed the rental.

Supporters of the plan also seek to justify it by asserting that, if, contrary to the fact, the trustees had adopted the lease and paid the stipulated rental, the estate's obligation to the date covered by such payments would have been discharged even though the plan subsequently rejected the lease, the contention apparently being that had the trustees adopted they would have become parties to the lease and would have been entitled to enforce its provisions. In this connection they rely upon the following provision of Section 77(b):

> "The adoption of an executory contract or unexpired lease by the trustee or trustees of a debtor shall not preclude a rejection of such contract or lease in a plan of reorganization approved hereunder, and any claim resulting from such rejection shall not have priority over any other claims against the debtor because such contract or lease had been previously adopted."

This must mean that a rejection in the plan nullifies a prior adoption by the trustee, leaving the case as if the trustee had never adopted. Except for the statutory provision, an adoption by the trustee, having the effect of making him a party to the contract, would entitle the other contracting party to a claim for damages against the trustee, payable on a parity with other trustee's obligations, upon a later rejection of the contract. Thus in *United States Trust Co.* v. *Wabash Railway*, 150 U. S. 287, this Court said (p. 300):

> "* * * If he elects to adopt a lease, the receiver becomes vested with the title to the leasehold interest,

and a privity of estate is thereby created between the lessor and the receiver, by which the latter becomes liable upon the covenant to pay rent."

The statute denies the existence of such a claim for damages against the trustee, thereby requiring the conclusion that under such circumstances the trustee is not to be deemed a party to the contract. In other words, the statute requires that a rejection in the plan shall produce the same legal results as a rejection by the trustee.

If, however, the opposite view be taken, namely, that an adoption by the trustee does make him a party to the contract and is not nullified by a later rejection in the plan, as the supporters of the plan contend, then it is clear that the situation here is not what it would have been had the trustees adopted. Under such circumstances the other contracting party must be entitled to enforce the contract against the trustee up to the date of rejection. Had the trustees here adopted the lease and thereby made the estate a party to it for the purpose of entitling the estate to claim its benefits, the estate would have become obligated to perform its obligations and to make good all defaults under it up to the date of rejection. *Cf. Greif Bros. Cooperage Co.* v. *Mullinix*, 264 Fed. 391, 397; *Westinghouse Electric & Mfg. Co.* v. *Brooklyn Rapid T. Co.*, 6 F. (2d) 547, 551; *Atchison, T. & S. F. Ry. Co.* v. *Hurley*, 153 Fed. 503, 510, affirmed on other grounds, *Hurley* v. *Atchison, Topeka & Santa Fe Ry.*, 213 U. S. 126.

Furthermore, under such a relationship, the lessor would not have been responsible for any losses that might have been incurred by the trustees in their operation of the property. The trustees have never adopted the lease and the estate is not now entitled, when it finds, after the event, that the operation has resulted in profits rather than losses.

to insist that the situation be treated as it might have been had the trustees pursued a different course of conduct.

The supporters of the plan also contend that the facts give rise to "special equities" which entitle the estate to retain the earnings of our property. The Commission's reports contain no such findings and there is nothing to suggest that the Commission based its determination of the effective date of rejection upon any such consideration.

The principle of "relation back" was itself evolved for the purpose of doing equity. Because of the necessity of permitting a receiver or trustee to investigate the relative burdens and benefits of leases, he was given the privilege of retaining leased property for a reasonable time, without becoming obligated under the lease, in order to determine whether to adopt or reject. The principle that such adoption or rejection, when it occurs, takes effect as of the beginning of the proceeding, is designed to settle the ultimate rights of all concerned on the most equitable basis possible.

Thus, in *Central Manhattan Properties* v. *D. A. Schulte, Inc.*, 91 F. (2d) 728, the court stated (p. 730):

> "* * * Rather, he (the trustee) subjects the adjustment of his relations with the lessor to an equitable disposition throughout, which requires that they shall be fixed as though he had rejected the lease when he got the stay. If he had then known his mind, the court to which he addressed himself would have compelled him to surrender the premises without putting the lessor to his action; equity regards as done what ought to have been done; the rejection 'relates back.'"

Had the debtor's estate determined at the outset to reject the present lease, the lessor would either have resumed operation of its own property, or the debtor's trustees would have continued operation under subdivision (c) (6)

of Section 77. In either event the operation would clearly have been for the account of the lessor. The estate's privilege of withholding decision for a reasonable time is conferred for the purpose of permitting an informed judgment. When the decision has been reached the full purpose of the privilege has been served and the rights of the lessor should be no less than they would have been had there been no delay on the part of the estate.

There is apparently only one case in which the relation back doctrine has been refused application because of the existence of so-called "special equities." In *Pennsylvania Steel Co. v. New York City Ry. Co.* (*Second Ave. R. Co. v. Robinson*), 225 Fed. 734, the court refused to permit a receiver to recover rental payments which he had made in excess of the net earnings. The decision has since been expressly disapproved and in effect overruled by the contrary holding of the same court in *Palmer v. Palmer*, 104 F. (2d) 161, 164. Furthermore, the same court in *Westinghouse Electric & Mfg. Co. v. Brooklyn Rapid T. Co.*, 6 F. (2d) 547, 551, declared that under the ruling in the *Second Avenue* case the debtor's estate must be charged with all defaults under the lease up to the time of rejection, the *Second Avenue* decision having been based upon the premise that the receiver had kept the lessor from retaking its property by preventing it from having any defaults to complain of. In the present case, as heretofore pointed out, defaults already exceed $7,000,000 (R. 2170).

The *Second Avenue* decision at most was simply an application of ordinary principles of estoppel. A similar reference to the possibility of an estoppel arising against the debtor's estate is made in *Palmer v. Palmer*, 104 F. (2d) 161, where the court held that the lessor must repay all rental payments. The court said (p. 164):

> "* * * If he (the lessor) is relieved of liability, it is only because it would be inequitable to compel him to restore what he did not know he might be called upon to restore, when he received it; and there may indeed be cases of individual lessors who have so far adjusted their affairs in actual ignorance of the contingent nature of the payments, that it would be unfair to compel them to do this."

The only other "special equity" referred to in the decisions arises when the net earnings of the leased property do not fully reflect the benefit derived by the debtor's estate therefrom. Thus, in *Pennsylvania Steel Co.* v. *New York City Ry. Co.*, 198 Fed. 721, the court said (p. 730, n. 3):

> "Exceptions to the rule that a receiver is obliged to account only for earnings are established in cases when the leased property is in itself non-producing and yet is a benefit to the system as a whole, e.g., a depot or terminal, and would undoubtedly be established in a case where a leased road is not wholly non-producing but the net earnings furnish no fair criterion of its value to the system, e.g., a feeder or connecting line. In such cases the special equities would require a receiver to pay a reasonable rental."

In other words, the doctrine of relation back is itself a summation of the equities of the situation. As in any other field of the law, the conduct of a party may create an estoppel against him, but in the absence of the essential elements of estoppel the relation back doctrine expresses the equitable result in all cases. The accounting required by the doctrine may take into account factors which demonstrate that the net earnings as such do not fully reflect the benefits obtained by the debtor's estate, but this does not, of course, defeat the right to the accounting.

In the present case there is nothing in the facts, or in the Commission's findings, which would in any way sup-

port a claim that the elements of estoppel exist, and apparently no such claim is made. Under such circumstances, the decisions without exception require an accounting of the earnings from the beginning of the proceeding.

The facts which the supporters of the plan assert create "special equities" entitling the estate to retain the entire earnings of the Terre Haute properties in excess of the current Terre Haute bond interest lend no support to their contention.

The fact, or rather the alleged fact, upon which major reliance is placed is that the estate has paid the stipulated rental as it fell due. This is simply a reiteration, in a different form, of the contention (heretofore discussed) that operation is not for the account of the lessor where the earnings exceed the rent. It is simply a claim that the estate may appropriate the earnings, for whatever period may be desired, by paying out of those same earnings amounts equal to the rental stipulated in the lease which the estate has repudiated.

Payment of an amount equal to the rental can in no way prejudice the estate if it would have been liable for a greater amount (*i. e.*, the full earnings) had such payment not been made. If the estate is now required to account for the entire net earnings it will be in no different position than if it had made none of the rental payments, for upon the accounting it will, of course, be entitled to a credit for the payments already made. *Westinghouse Electric & Mfg. Co.* v. *Brooklyn Rapid T. Co.*, 6 F. (2d) 547, 550.

Furthermore, it should be noted that the lessor was entitled to the payments under any circumstances. In the event of adoption of the lease, it was entitled to them as rent; in the event of rejection, it was entitled to them as part payment of the earnings of its property. The making

of the payments in no way affects the principle that, if the lease is rejected, the operation is for the account of the lessor. *Westinghouse Electric & Mfg. Co.* v. *Brooklyn Rapid T. Co.*, 6 F. (2d) 547; *Palmer* v. *Palmer*, 104 F. (2d) 161.

In any event, however, the fact is that the estate has not performed all of the obligations falling due under the lease. It has failed to pay the principal on one issue of the lessor's bonds which has matured (R. 193), and has failed to perform the undertaking to maintain the lessor's equipment (R. 2170). The supporters of the plan assert that the obligation to pay bond principal "does not involve rent but simply an advance to the Terre Haute repayable at the termination of the lease." The right to such an advance is of value, particularly where, as here, it is repayable in bonds of the lessor at par, and this covenant formed a part of the consideration for the lease. With respect to the obligation to maintain equipment the supporters of the plan state that "the question of equipment vacancies concerns not rent but only a covenant to replace part of the original property *used up during the lease.*" (Italics ours.) Certainly the estate cannot use up a portion of the lessor's property, turning back only such part as remains, and at the same time retain the profits which it has derived from its use of the property.[9]

If payment of "rent" can ever create an equity entitling the estate, even though it repudiates the lease, to retain profits it has obtained from the lessor's property, it can

[9] It should be noted that the earnings figures for the Terre Haute contained in the record reflect earnings after depreciation charges. In other words, the estate has derived from its possession of the Terre Haute property not only the amount of net earnings shown by the record, but also an additional amount of cash equivalent to the amount of depreciation charged against Terre Haute equipment.

only be where the estate has furnished to the lessor, up to the time of rejection, the entire consideration for which the lessor contracted. It is apparent that the current annual payments required of the lessee under the Terre Haute lease (*i.e.*, the bond interest) were fixed with reference to the lessee's other covenants, and that they would have been required to be larger if the lessee had not assumed such other covenants. *Cf. In Re United Cigar Stores Co. of America*, 86 F. (2d) 629, 633, certiorari denied, 300 U. S. 679.

The contentions of the supporters of the plan that "special equities" arise out of the debtor's ownership of 97% of the stock of the Terre Haute and out of the alleged fact that the Terre Haute earnings are substantially dependent on system operation merit little consideration.

The contention based on the Milwaukee's stock ownership assumes that it is equitable for stockholders to participate in earnings before reasonable provision has been made for full payment of bondholders. If the lease is to be rejected the Terre Haute, in order to resume operation, will have to set up working capital, replace equipment which the Milwaukee and its trustees have used up and not replaced, and create a sinking fund to provide against the approaching maturities of its bonds. No part of the Terre Haute earnings can properly be diverted to stockholders until adequate provision has been made for these requirements.

The contention that the earning power of the Terre Haute is dependent on system operation has no bearing on the question whether there should be an accounting. It is in large part based upon the fact that a part of the traffic carried by the Terre Haute consists of fuel coal purchased by the Milwaukee from mines on the Terre

Haute lines. The fact that the Milwaukee owns the coal which the Terre Haute transports does not entitle it to retain the Terre Haute earnings; for it is not entitled to free transportation of its fuel coal. In any event, however, the question whether the Milwaukee makes any contribution to the Terre Haute earnings, and if so, the amount that it is entitled to receive on account thereof, can only be determined upon an accounting. *The question here is whether there shall be an accounting; not what the results of the accounting will be.* There is here no record, and no opportunity has ever been presented to make one, on which the Court can properly decide whether the Milwaukee is entitled to any credit, and, if so, what the amount of the credit should be.

We submit that every equitable consideration requires application of the well established principle that, in the event of rejection, operation after the institution of the proceeding is for the account of the lessor. The debtor's estate has at all times been free to take whatever action it desired. It has had the privilege of turning the property over to the lessor at any time or of keeping it and making such provisional payments as it wished, and it has had complete freedom of choice as to whether to adopt or reject. Had it chosen to adopt, the Terre Haute would have been bound by the lease and would have been required to grant its benefits to the estate from the beginning of the proceeding. It has, however, chosen to reject. Under that choice, had there been losses, or net earnings less than the stipulated rental, the Terre Haute would have been required to return the payments which it has received and to pay the losses, or be satisfied with the net earnings, as the case might be. The Terre Haute has thus been subject to the entire risk of loss and is now entitled to the entire net earnings. The denial of this right by the plan requires affirmance of the judgment of the Circuit Court of Appeals.

For more than seven years the debtor's estate has held and used our property, and has derived substantial profits therefrom. Very substantial defaults in the performance of the lessee's obligations have been permitted to occur. It is now proposed that the estate shall repudiate the lease, return the property in its depreciated condition, deny to the lessor the full consideration for which it contracted, and at the same time retain the earnings which have been obtained from the lessor's property.

Clearly the estate must be subject to some obligation on account of its possession and use of our property. This obligation, of course, must be paid by the trustees; it cannot be relegated to the status of an unsecured claim against the debtor.

The amount of the obligation cannot be measured simply by what the estate desires to pay. Either the lease must be held to be binding on both the estate and the lessor until the date of rejection, in which event the estate must make good all defaults which have occurred up to that date, or it must be held that the lease has not been binding on either the estate or the lessor; in which event the estate must account for the entire net earnings.

We respectfully urge that the principles applicable to the determination of the estate's obligation be declared by this Court to the end that the future progress of the reorganization may not be subjected to the delays that must otherwise be caused by the efforts of the security holders of the Milwaukee to retain for their own benefit the earnings of our property.

CONCLUSION

The Circuit Court of Appeals was correct in holding that "it is quite impossible to approve of the disposition of the

Terre Haute bond issues without having more specific findings" and that "whether this lease should not be now terminated presents a separate question, which can only be determined when findings are made." Rejection of the Terre Haute lease cannot be justified in the absence of findings, supported by evidence, that the lease is or will be burdensome to the lessee.

In any event, however, if the lease is to be rejected, the rejection must take effect as of the date on which the reorganization proceeding was instituted; the lessor's claim for damages must be measured as of that date; and the operation of the leased property after that date must be for the account of the lessor. The instant plan, by providing that the lease shall be rejected as of a date which is yet in the future, violates well established principles. This of itself requires affirmance of the judgment below.

Respectfully submitted,

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APPENDIX A.

(Terre Haute District Court Exhibits 16-23, introduced at R. 1686-1688.)

REVENUES AND NET INCOME OF TERRE HAUTE LINES ON TARIFF RATE BASIS

Year	Income before Terre Haute Rental	Terre Haute Rental, Interest* on T. H. Bonds & Corporate Expenses	Net Income to Milwaukee	Tons of Milwaukee Coal Hauled	Freight Revenue for Haul of Milwaukee Co. Coal
1924	$2,450,043	$1,047,333	$1,402,710	$2,572,135	$2,573,701
1925	3,399,133	1,049,368	2,349,765	2,721,512	2,627,270
1926	3,916,806	1,039,521	2,877,285	2,975,188	2,887,770
1927	2,837,618	1,039,393	1,798,225	2,787,266	2,993,039
1928	2,843,418	1,040,367	1,803,051	2,436,257	2,465,731
1929	3,106,361	1,040,854	2,065,507	2,731,552	2,753,061
1933	2,962,012	1,036,120	1,925,892	1,610,963	1,664,125
1934	2,826,982	1,034,223	1,792,760	1,626,238	1,741,701
1935	2,733,207	1,033,244	1,699,963**	1,724,306	1,853,674
1936	2,998,588	1,032,042	1,966,546	2,049,747	2,209,006
1937	2,854,169	1,033,482	1,820,687	2,019,181	2,059,872
1938	2,339,675	1,035,882	1,303,793	1,516,067	1,595,027
1939	3,115,992	1,034,684	2,081,308	1,807,131	1,935,416
1940†	3,411,621	1,109,430	2,302,191	1,785,416	
1941†	4,240,413	1,108,550	3,131,863		2,283,415

* Excluding interest on $1,515,000 T. H. Bonds owned by Milwaukee and pledged under its First & Refunding mortgage.

** This figure should be increased by $39,000 (R. 1688).

† The figures for 1940 and 1941 are from compilations supplied by the debtor's trustees since the hearings in the District Court.

The data for years 1921, 1922, 1923, 1930, 1931, 1932 are not included because not available.

REVENUES AND NET INCOME OF TERRE HAUTE LINES ON A COST OF SERVICE BASIS

Year	Income Available For Interest—Cost of Service Basis	Interest on T. H. Bonds including those Pledged Under Mil. 1st & Ref. Mtg.*	Net Income on Cost of Service Basis after Interest Rental
1936	$2,040,187	$1,099,330*	$ 940,857
1937	2,060,796	1,109,232*	951,564
1938	1,772,052	1,111,632*	660,420
1939	2,381,900	1,110,434*	1,271,466
1940†	2,692,266	1,109,430	1,582,836
1941†	3,353,775	1,108,550	2,245,225

* But without Terre Haute corporate expenses not exceeding $12,000 a year.

† The figures for 1940 and 1941 are from compilations supplied by the debtor's trustees since the hearings in the District Court.

APPENDIX B.

The provisions of Section 77 of the Bankruptcy Act (11 U. S. C. A. § 205) most pertinent to the issues dealt with herein are the following:

"(a) Any railroad corporation may file a petition stating that it is insolvent or unable to meet its debts as they mature and that it desires to effect a plan of reorganization. * * * Upon the filing of such a petition, the judge shall enter an order either approving it as properly filed under this section, if satisfied that such petition complies with this section and has been filed in good faith, or dismissing it, if he is not so satisfied. If the petition is so approved, the court in which such order is entered shall, during the pendency of the proceedings under this section and for the purposes thereof have exclusive jurisdiction of the debtor and its property wherever located, and shall have and may exercise in addition to the powers conferred by this section all the powers, not inconsistent with this section, which a Federal court would have had if it had appointed a receiver in equity of the property of the debtor for any purpose. * * *

"(b) A plan of reorganization within the meaning of this section * * * may reject contracts of the debtor which are executory in whole or in part, including unexpired leases; and may include any other appropriate provisions not inconsistent with this section.

"The adoption of an executory contract or unexpired lease by the trustee or trustees of a debtor shall not preclude a rejection of such contract or lease in a plan of reorganization approved hereunder, and any claim resulting from such rejection shall not have priority over any other claims against the debtor because such contract or lease had been previously adopted, * * * The term 'creditors' shall include, for all purposes of this section all holders of claims

of whatever character against the debtor or its property, whether or not such claims would otherwise constitute provable claims under this Act, including the holder of a claim under a contract executory in whole or in part including an unexpired lease.

"* * * In case an executory contract or unexpired lease of property shall be rejected, or shall not have been adopted by a trustee appointed under this section, or shall have been rejected by a receiver in equity in a proceeding pending prior to the institution of a proceeding under this section, or shall be rejected by any plan, any person injured by such nonadoption or rejection shall for all purposes of this section be deemed to be a creditor of the debtor to the extent of the actual damage or injury determined in accordance with principles obtaining in equity proceedings. * * *

"(c) After approving the petition:

* * *

"(2) The judge shall fix the amount of the bond of every trustee. * * * The trustee or trustees so appointed, upon filing such bond, shall have all the title and shall exercise, subject to the control of the judge and consistently with the provisions of this section, all of the powers of a trustee appointed pursuant to section 44 of this Act or any other section of this Act, and, to the extent not inconsistent with this section, if authorized by the judge, the powers of a receiver in an equity proceeding, and, subject to the control of the judge and the jurisdiction of the Commission as provided by the Interstate Commerce Act as now or hereafter amended, the power to operate the business of the debtor.

* * *

"(6) If a lease of a line of railroad is rejected, and if the lessee, with the approval of the judge, shall elect no longer to operate the leased line, it shall be the duty of the lessor at the end of a period to be fixed by the judge, to begin the operation of such line, unless the judge, upon the petition of the lessor, shall decree after hearing that it would be impracticable and con-

trary to the public interest for the lessor to operate the said line, in which event it shall be the duty of the lessee to continue operation on or for the account of the lessor until the abandonment of such line is authorized by the Commission in accordance with the provisions of section 1 of the Interstate Commerce Act as amended."